

Kentucky Securities Law

A guide for law
enforcement officers
and prosecutors



Presented by the
Office of Financial Institutions
Division of Securities



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Introduction

Each year, hundreds of Kentuckians lose millions of dollars of their hard-earned savings to fraudulent investment schemes. People typically lose from \$10,000 to \$30,000; however, individual losses of \$200,000 or more also happen.

The Kentucky Office of Financial Institutions, through its Division of Securities, is charged with protecting Kentuckians from securities fraud.

This booklet is designed to give law enforcement officers and prosecutors a basic working knowledge of Kentucky's securities laws. Securities crimes are becoming more prevalent each year. Chapter 292 of the Kentucky Revised Statutes governs the offer and sale of securities in our state.

Securities Types

KRS 292.310 (18) defines the term security.

Generally, a security is a passive investment of money in virtually any sort of enterprise. Examples of purchases of securities include the purchase of stock in a company, the loan of money on a note or debenture to a company or an agreement to invest in a company that does not yet exist. Most securities fall into one of three categories:

Stocks, Bonds and Limited Partnerships

This category includes instruments commonly recognized as securities. Stocks and bonds are the most common kinds of securities sold in Kentucky, but they are not the only kinds of securities involved in scams. Fraud perpetrators often attempt to disguise the investment to make it look like something other than a security.

A security commonly used in scams is the limited partnership interest. These interests are often used as the investment vehicle for some real estate and start-up business scams. In a limited partnership, the victim puts in money and will supposedly receive a set percentage of the profits of the venture, but will have little or no say about how the money will be spent or about the management of the venture.

Even if the enterprise is not *called* a limited partnership, it may still be a limited partnership in substance. For example, promoters (the persons behind the enterprise or scam) will offer investment opportunities labeled as general partnerships or limited liability company interests. Depending on the circumstances, these labels may only be an effort by the promoter to hide the fact that a security is being offered.

Investment Contracts

The investment contract is the most common kind of security involved in fraud cases, probably because investment contracts cover a wide range of investment opportunities. Investment contracts have the following characteristics:

- They involve the investment of money in a common enterprise.
- Investors contribute their money with the expectation that they will make a profit.
- The profit is expected by the investors to be generated primarily by the managerial efforts of others.

“Common Enterprise” means that the investor’s money is pooled with other investors’ money or that the promoter’s and the investor’s fortunes are intertwined (the investor’s profits are tied to how well or poorly the promoter’s enterprise does). “Efforts of others” means the investor depends on the efforts of others in order to receive a profit from the investment.

An example of an investment contract is the investment in 10 cubic feet of “in-ground ore” (in other words, dirt) that can only be mined if all the investors’ pool their individual interests so that mining becomes economically feasible. Other examples of investment contracts are interests in viatical settlement contracts, interests in pay

telephones or ATM machines, and interests in a managed condominium.

Notes and Evidence of Indebtedness

Notes and evidence of indebtedness include writings that promise to pay a certain sum at a certain time or upon a certain event. These are simply loans evidenced by a promissory note or a bond or debenture. Notes and evidences of indebtedness are the second most common type of securities fraud, often because people believe loans are not securities. Because these types of transactions are not readily identified as securities, victims will often overlook the securities aspect of a transaction.

Examples of Securities Cases Involving Fraud

A local insurance agent sold investments totaling more than \$3 million to 41 investors. The investors consisted primarily of elderly retirees who were fellow church members or long-time insurance clients of the agent. He told them their money would be placed in a legitimate, high-interest bearing investment account or used to expand his business operations. He issued the investors promissory notes, which he defaulted on at maturity.

Representatives of a local business held seminars touting various investment products promising high returns and no risk. They sold investments

totaling at least \$800,000. The majority of the investments sold were in the form of certificates of deposit issued by a bank organized and located in Grenada. Investors were assured the certificates of deposit were safe and insured against loss. The government of Grenada has appointed a liquidator for the bank that issued the certificates, and his initial report indicates there will likely be a significant shortfall to creditors and depositors of the bank.

A local man ran advertisements for high-interest certificates of deposit. He sold investments in the certificates to approximately 40 people. Investors, primarily elderly retirees who had previously invested in traditional certificates of deposit at local banks, understood they could cash in their certificates after one year and receive their principle and interest. The certificates turned out to have maturity dates as long as 20 years. When investors attempted to cash in the certificates prior to maturity, they found they could be subject to substantial losses to their principle investments.

Indications of Securities Violations

- Someone is promoting an investment opportunity.
- The investment opportunity is a “sure thing,” promises a high rate of return with little risk or involves some unusual type of investment, e.g. radically new technology, old bearer of gold bonds, offshore bank debenture or certificates of deposit.

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- The information in the promotional literature or prospectus does not make sense or cannot be easily verified.
 - The investor is required to sign special non-circumvention, nondisclosure or secrecy documents.
 - The investor is required to wire or send money to another state or country.
 - Share certificates, certificates of deposit or other documents given to investors as evidence of their investment appear poorly designed, contain spelling errors or bad grammar, or are restrictive in ownership or ability to be sold or transferred; or, conversely, the investment promoters send slick brochures to the investors by courier or express mail and offer to pick up the investor's check by the same method.
 - The person or persons offering or selling the investment omit, fail to disclose or make false statements about the investment, its risk, the financial history of the promoter (e.g. bankruptcies and judgments), prior securities violations or disciplinary action against a securities licensee.
 - The opportunity involves participation in a Ponzi scheme, pyramid or similar scheme, in which old investors are paid from money received from new investors.

Preliminary Securities Investigation Checklist

If you suspect violations involving securities laws, you should contact the Securities Enforcement Branch of the Kentucky Office of Financial Institutions early in the investigation. Enforcement investigators and lawyers can help you determine whether or not the matter involves a security, identify and interview involved persons, gather evidence, and assist in the investigation of your case.

As in any investigation, you should attempt to obtain basic facts behind the complaint, identify the person or companies involved, and establish the order in which events occurred. Securities cases are often document-intensive. Preserve any documents or records you find and advise the complainant or victim to do the same. In an ongoing scheme, advise the complainant or victim to keep notes of all conversations with the parties involved.

Basic Information and Questions

- Identify the complainant and potential victims. Who invested the money? Was the money invested individually or did a group make the investment? How was the money for the investment paid? Does the investor have a copy of the check (front and back)?

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- Identify the person (s) who offered or sold the investment. What is the background of the seller? Where can the seller be found? How did the investor meet the seller?
 - Identify the entities or companies involved or the issuer of the investment. Where are they located?
 - What type of investment was offered? Was it stock in a company? An investment program? Part of a limited partnership?
 - Describe the investment. How did it work? Who created or organized it?
 - What was the complainant told about the investment? Was the complainant promised a return on the investment? How much?
 - Did the investor have any control over the funds invested or the way the program was run?
 - Were there any commissions, fees or other monies paid to the seller? Did the issuer or company charge any fees for handling the account?
 - Did the investment work as promised? Did the investor receive any funds, and were any of the proceeds reinvested?

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- Is the investor satisfied with the investment? Has the investor complained to the seller or issuer? What was the result? Has the investor obtained legal counsel or taken legal action?
 - Obtain materials used to promote the investment program such as brochures, or a prospectus. Obtain receipts, copies of checks, money orders, wire transfers or other means of payment that may show where the funds were sent.
 - Obtain resumes, licenses or other materials that may identify the sellers or promoters and their office locations.
 - Obtain correspondence, e-mail, faxes or other records with letterhead or telephone numbers and envelopes that would evidence use of the U.S. mail.
 - Obtain investment contracts, promissory notes, stock or share certificates, partnership agreements, or certificates of participation.
 - Obtain documents that might show whether or not the investor was able to control or direct any activity related to the investment. For example, was the investor able to exercise a vote or participate in company decision-making?
 - Obtain account statements, commission receipts, checks or other evidence of payment of commissions or account fees.

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- Obtain correspondence, receipts, check stubs showing proof of payment, bank statements or deposit receipts from the investor. Obtain documents showing that money or investment proceeds were reinvested.
 - Obtain correspondence concerning investor complaints, either to the seller or issuer, or to any government agencies. Identify legal counsel on both sides, if any. Obtain copies of legal documents or court filings and the name of the court and docket number.
 - Provide the Securities Division with a copy of your initial police report.



Kentucky Securities Statutes

Three provisions of the Securities Act of Kentucky are most commonly violated by those selling securities: KRS 292.320 (anti-fraud), KRS 292.330 (registration of firms and individuals) and KRS 292.340 (registration of securities). A willful violation of the Securities Act is a Class D felony in Kentucky.

KRS 292.340

This statute requires all securities offered or sold in Kentucky to be registered with the Securities Division unless the securities themselves or the transaction in which they are offered or sold are exempt or the securities fall within the definition of “federally covered securities.” Exempt securities include those that are U.S. government-issued or backed, those listed on major exchanges (such as NYSE, ASE or NASDAQ NMS), or so-called investment grade bonds. Exempt transactions include sales to institutions (such as banks or insurance companies), unsolicited trades executed through licensed securities broker-dealers and some private sales.

KRS 292.330

This provision requires all persons and entities offering or selling securities in Kentucky to be licensed with the Division to conduct such offers or sales. The Division has access to a national database that contains information on persons and entities licensed to sell securities in any state. A

person who offers and sells a security in Kentucky while not licensed – even in an isolated circumstance – may violate the statute.

KRS 292.320

This provision makes it unlawful for any person to engage in fraud in connection with the sale of a security.

Generally, the use of any fraudulent scheme or business practice violates this provision. This could include the sale of interests in a phony or nonexistent company or the use of investor funds to pay off previous investors.

Specifically, under KRS 292.320(1)(b), fraud is committed by the omission or misrepresentation of a “material fact.” A material fact is any fact that a reasonable investor would find important to his or her investment decision. Material facts include the following:

- Money invested was not used for the purpose the investor was told it would be.
- The seller has been the subject of previous convictions or administrative orders concerning securities violations.
- Previous investor money was not used for the stated purpose.

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- Earlier, similar business ventures resulted in losses to investors.

Your own judgment is useful in determining the materiality of a fact: Would the disclosure of a particular fact have been important to you if you were making a decision to invest?

The Bottom Line

Securities crimes involving unregistered or unlicensed sales are almost entirely paper cases. The fact the seller did not know that the instrument was a security or that registration or licensing was required does not constitute a defense.

Do not be concerned with exemptions from securities registration if the elements of an unregistered, unlicensed or fraudulent sale come to your attention. The exemptions can be easily lost and the anti-fraud provision applies to all securities transactions even though they can be exempt from registration.

Further, the exemptions are an affirmative defense, which means that the person claiming reliance on an exemption must claim and prove it. The burden is on a defendant to show that he or she is entitled to claim an exemption.

Resources Available to Law Enforcement Personnel

The Securities Division has nationwide contacts in the securities industries. In addition, the Division can access proprietary databases from the National Association of Securities Dealers, the North American Securities Administrators Association and the National White Collar Crime Center.

Law Enforcement Assistance and Investor Education

The Securities Division staff is available to provide assistance to law enforcement agencies and Kentucky prosecutors interested in improving their ability to combat securities crimes.

The Securities Division also operates an Investor Education Program, which provides non-biased information about investing and protecting your money. Speakers and written materials for groups of any size are available free of charge. Law enforcement agencies with crime prevention programs are encouraged to use the program. For more information on the Investor Education Program, call the program coordinator (800) 223-2579.

The Securities Division Enforcement Branch

The Enforcement Branch handles all matters relating to the investigation of violations of the Kentucky securities laws.

Securities transactions subject to investigation by the Securities Division are rarely registered with the Division. Because nearly all securities cases that come to your attention involve some sort of fraud, it is unlikely that a fraud perpetrator would allow the offering to be scrutinized by Securities Division examiners. It is possible that an offering may qualify for an exemption from registration, but for the most part, fraudulent offerings fail to qualify for exemption.

If you receive a citizen complaint that you believe involves a security, please do not hesitate to seek assistance from the Securities Division. Send a copy of your report or notes to the Securities Division. It will be reviewed and assigned to an enforcement branch investigator, who will contact you.

To contact the Securities Division, please call or fax information to the numbers listed below. If you have questions, want to discuss particular facts or want to meet with our staff, please call.

Office of Financial Institutions
Division of Securities
1025 Capital Center Drive, Suite 200
Frankfort, KY 40601

Phone: 1-800-223-2579
Fax (502) 573-2182
www.kfi.ky.gov



Commonwealth of Kentucky
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To request additional copies of this document at no cost, call or write: 1-800-223-2579, Office of Financial Institutions, Division of Securities, 1025 Capital Center Drive, Suite 200, Frankfort, KY 40601.

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